Editor's note: 89 I.D. 480

YATES PETROLEUM CORP. ET AL.

IBLA 81-793 Decided September 24, 1982

Appeal from decision of Wyoming State Office, Bureau of Land Management, holding noncompetitive oil and gas lease to have terminated by operation of law. W-28314.

Set aside and remanded.

1. Oil and Gas Leases: Termination -- Oil and Gas Leases: Unit and Cooperative Agreements -- Oil and Gas Leases: Well Capable of Production -- Words and Phrases

"Paying quantities." For the purposes of the extension provision of 30 U.S.C. § 226(j) (1976) relating to leases committed to a unit plan of development, "paying quantities" requires production sufficient to recover the costs of operation and marketing but does not include recovery of drilling expenditures.

APPEARANCES: David R. Vandiver, Esq., Artesia, New Mexico, for appellants.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Yates Petroleum Corporation (Yates), Aminoil USA, Inc., and the Estate of William J. Helis have appealed from a decision of the Wyoming

State Office, Bureau of Land Management (BLM), dated May 28, 1981, holding appellants' noncompetitive oil and gas lease, W-28314, to have expired at the end of its primary term because no drilling operations were being conducted over the expiration date of the lease, and the lease was deemed "not eligible for extension" under 43 CFR 3107.2-3.

Oil and gas lease W-28314, consisting of sec. 29 and lots 1, 2, 3, E 1/2, E 1/2 W 1/2 sec. 30, T. 26 N., R. 95 W., sixth principal meridian, was issued to Jack J. Grynberg, effective May 1, 1971, for a term of 10 years. Appellants are the current record titleholders of the lease as a result of several mesne assignments. On February 8, 1979, appellants agreed to commit the lease to the Osborne Draw Unit Agreement (No. 14-08-0001-18076), which was approved July 26, 1979, effective that date, for an initial term of 5 years.

On July 25, 1979, Yates, the unit operator, commenced drilling the Osborne Draw Federal Unit No. 1 (Unit No. 1) well in the NE 1/4 NW 1/4 sec. 4, T. 25 N., R. 95 W., sixth principal meridian, to a total depth of 15,004 feet. On September 20, 1980, the well was completed in the Lewis formation, and flowed 280,000 cubic feet of gas per day. Reserves were estimated to be 4.1 billion cubic feet of gas.

By letter dated February 9, 1981, Yates submitted information obtained from its drilling activities and requested that the Area Oil and Gas Supervisor, 1/ designate the Unit No. 1 well a "commercial well." In response to

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1/ The Conservation Division, Geological Survey, was reorganized effective June 30, 1982, and is now known as the Minerals Management Service (MMS), and the officials now bear different titles. Secretarial Order No. 3071 (Jan. 19, a subsequent request by the Geological Survey (Survey) for additional test flow data, Yates submitted information by letter dated May 29, 1981, which indicated that an estimated 4.558 billion cubic feet of gas was producible from the Unit No. 1 well.

At the same time these actions were occurring, however, the District Supervisor, Geological Survey, Rock Springs, Wyoming, by memorandum dated May 4, 1981, advised BLM that there were "[n]o drilling operations" which would qualify the lease for an extension. On the basis of this memorandum, BLM held the lease to have terminated in its May 28, 1981, decision, which decision was received by appellants on June 1, 1981.

In their statement of reasons for appeal, appellants contended that, as of July 16, 1981, Survey had not acted on Yates' request for a commercial determination regarding the Unit No. 1 well. They argued that the well "although completed and physically capable of producing, is still shut-in due to * * * Yates' inability to obtain a pipeline connection." They requested that all action be stayed until Survey determines whether the Unit No. 1 well is a well capable of producing in paying quantities and, if Survey determined that it was not, they requested that we refer this matter for a fact-finding hearing so that they might submit evidence to establish that it was a well capable of production in paying quantities.

Section 17(j) of the Mineral Leasing Act, as amended, 30 U.S.C. § 226(j) (1976), provides, inter alia, that a noncompetitive oil and gas

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fn. 1 (continued)
1982), 47 FR 4751 (Feb. 2, 1982). However, for simplicity we shall refer to Survey and its officials as they were known at the time of their actions.

lease with a primary term of 10 years, which has been committed to a unit agreement, shall continue in force as long as the lease remains committed, provided that production is had in paying quantities prior to the expiration date of the lease. 2/ See 43 CFR 3107.4-2. Accordingly, as long as production is had in paying quantities on any lease committed to a unit agreement, that production will be credited to all of the leases so committed. Even in the absence of actual production, the presence of a well capable of producing oil or gas in paying quantities completed anywhere in the unit, subsequent to the effective date of the unit agreement but prior to the expiration date of a unitized lease, will continue that lease beyond its primary term. Burton/Hawks, Inc., 47 IBLA 125 (1980); Corrine Grace, 30 IBLA 296 (1977).

The question, therefore, is whether the Unit No. 1 well was a "well capable of producing oil or gas in paying quantities." According to documents provided by the Mineral Management Service (MMS), Survey, by letter dated July 31, 1981, determined that the Unit No. 1 well was not capable of producing in paying quantities, and so informed appellants. As noted above, appellants have requested a hearing on the question of the well's capacity to produce oil or gas in paying quantities if a determination were subsequently made that the well was not capable. It is, indeed, the policy of the Board to afford an appellant in such circumstances the option of requesting a hearing. See Burton/Hawks, Inc., supra.

2/ Section 17(e) of the Mineral Leasing Act, as amended, 30 U.S.C. § 226(e) (1976), provides that a lease may also be extended for 2 years where actual drilling operations were commenced under the unit agreement prior to the expiration date of the lease and are being diligently prosecuted at that time. See 43 CFR 3107.2-3. Appellants, however, do not argue that section 17(e) applies herein.

We note, however, that included with the documents provided by MMS was a copy of a request for termination of the Osborne Draw Unit, dated July 27, 1981, and signed by more than 75 percent of the owners of the working interests as required by section 20 of the unit agreement. The signatories include all three of the appellants before us. In their request, appellants stated: "The Osborne Draw Federal Unit Well No. 1 located in Unit C of Section 4, Township 25 North, Range 95 West, Sweetwater County, Wyoming, was drilled to a total depth of 15,004 feet, and completed as a non-commercial well in the Lewis Formation." (Emphasis supplied.) On July 3, 1981, the Acting Deputy Conservation Manager approved their request and terminated the unit agreement effective that date.

It seems reasonably clear that, at least as of July 27, 1981, appellants were convinced that the Unit Well No. 1 was not a commercial completion. This, however, does not end the matter. The question which remains to be examined is whether the admission that the well was completed "as a non-commercial well" is inconsistent with appellants' assertions that the lease W-28314 was subject to extension pursuant to the provisions of section 17(j) of the Mineral Leasing Act of 1920, as amended, 30 U.S.C. § 226(j) (1976). We hold that these two statements are not necessarily inconsistent.

[1] The term "commercial well," just like the term "paying quantities," is amenable to differing interpretations dependent upon the context of its usage. Thus, the term "commercial well" has been defined as "a well capable of production in paying quantities, which in this sense usually means a well that will make a profit over the costs of drilling, equipping, completing and operating it." Williams and Meyers, Manual of Oil and Gas Terms (3d ed.

1971), at 69. But, when terms such as "commercial well" of "commercial quantity" appear in the habendum clause of an oil or gas lease, they are normally defined as including costs of production and marketing but excluding recapture of the costs of drilling. See, e.g., Texaco, Inc. v. Fox, 618 P.2d 844, 847-48 (Kan. 1980). In this regard, therefore, the term "commercial well" is synonymous with "a well capable of producing in paying quantities," since it has long been recognized that where that latter phrase is found in the habendum clause, it, too, encompasses recovery only of the costs of production and marketing and excludes drilling costs. See Benedum-Trees Oil Co. v. Davis, 107 F.2d 981, 985 (6th Cir.), cert. denied, 310 U.S. 634 (1939); Fick v. Wilson, 349 S.W.2d 622, 625 (Tex. Civ. App. 1961); John G. Swanson, 66 IBLA 200, 202 (1982); Amoco Production Co., 41 IBLA 348, 351 (1979).

Notwithstanding the foregoing, however, it must be recognized that where the term "production in paying quantities" appears in contexts other than the habendum clause it might well partake of a more restricted meaning. This is clearly the case of its use in section 9 of the unit agreement herein. In relevant part, that section provides:

> DRILLING TO DISCOVERY. Within 6 months after the effective date hereof, the Unit Operator shall begin to drill an adequate test well at a location approved by the Supervisor, unless on such effective date a well is being drilled conformably with the terms hereof, and thereafter continue such drilling diligently until the upper 300 feet of the Lance formation has been tested or until at a lesser depth unitized substances shall be discovered which can be produced in paying quantities (to-wit: quantities sufficient to repay the costs of drilling, completing, and producing operations, with a reasonable profit) or the Unit Operator shall at any time establish to the satisfaction of the Supervisor that further drilling of said well would be unwarranted or impracticable, provided, however, that Unit Operator shall not in any event be required to drill said well to a depth in excess of 7,800 feet. Until the discovery of a deposit of

> unitized substances capable of being produced in paying quantities, the Unit Operator shall continue drilling one well at a time, allowing not more than 6 months between the completion of one well and the beginning of the next well, until a well capable of producing unitized substances in paying quantities is completed to the satisfaction of said Supervisor or until it is reasonably proved that the unitized land is incapable of producing unitized substances in paying quantities in the formation drilled hereunder. [Emphasis supplied.]

Clearly, as used in this context, "paying quantities" incorporates a requirement that the costs of drilling must be recouped. Based on this provision, which also appears in the standard form unit agreement (see 30 CFR 226.12), Survey has taken the position that:

> [T]o be initially considered a unit well, a well must be capable of production in such quantity as will pay a profit to the lessee over and above the normal costs of drilling, completing and equipping the well, maintaining the lease, operating the well, and marketing the product. * * *
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> Once a well has been determined to be a unit well, all leases committed to the unit are eligible for extension (in accordance with Section 20 of the Standard Form of Unit Agreement for Unproved Areas) so long as the unit contains a well capable of producing oil or gas in sufficient quantities to pay the cost of production, i.e., the cost of maintaining the unitized leases and operating the well, including normal marketing costs. This is the same criteria used for individual lease extension.

Conservation Division Manual at 645.6.3D.

Contrary to the last sentence of the Conservation Division Manual quoted above, the criteria established by the manual for extension of leases committed to a unit is not the same as that applied for an individual lease. Thus, under the Manual, if an initial well is drilled in a unit with production merely sufficient to allow a profit over continuing operating and marketing expenses, but insufficient to cover the costs of drilling, such well will not serve to extend leases committed to the unit. Such a well would, however, extend an individual lease if in existence at the end of its primary term. For reasons which we set forth, even giving due deference to Survey's long experience, we cannot agree to its interpretation that, in order to extend a lease committed to a unit beyond its expiration date, the well must be able to recover the costs of drilling as well as the costs of operating and marketing.

First, it is not in accord with the statutory language of section 17(j), 30 U.S.C. § 226(j) (1976). Thus, section 17(j) states, in relevant part:

> Any * * * lease [other than a 20-year lease] issued under any section of this chapter which has heretofore or may hereafter be committed to any such [unit] plan that contains a general provision for allocation of oil or gas shall continue in force and effect as to the land committed so long as the lease remains subject to the plan: Provided, That production is had in paying quantities under the plan prior to the expiration date of the term of such lease.

It is to be noted that the above-quoted proviso is in the nature of a habendum clause and, further, that the reference to production in "paying quantities" replicates the provision found at 30 U.S.C. § 226(e) (1976), which establishes the respective primary terms for competitive and noncompetitive leases and provides that "each such lease shall continue so long after its primary term as oil or gas is produced in paying quantities." Since it has long been settled that "paying quantities," as used for individual lease extension, only contemplates recovery of operating and marketing costs (see cases cited, infra), it is difficult to ascertain why the same phrase, used in the same context (for the purpose of extending the lease), should have a dissimilar meaning in section 17(j). 3/

Second, Survey's position ignores the different purposes behind the extension provision of the statute and the drilling requirement of section 9 of the unit agreement. The extension provisions, both in section 226(e) and in section 226(j) are, in effect, an award to the lessee who has developed his lease. Moreover, it serves to aid the conservation of the resource, since without it a lessee who was approaching the end of a fixed lease term might increase production in the short run without regard for total recovery since such recovery would not benefit him. 4/

It would, of course, make no economic sense to terminate a lease where a well had been drilled and could be profitably produced, even where it was apparent that total recovery would never equal total expenditures. From the

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3/ Indeed, the distinction between the meaning of the term production in "paying quantities" for purposes of the habendum clause regarding lease extension where only production sufficient to recover operating and marketing expenses is required and the meaning of the same term for purposes of defining the lessee's drilling obligations under a lease is well recognized. Transport Oil Co. v. Exeter Oil Co., 84 Cal. App. 2d 616, 191 P.2d 129 (Cal. App. 1948); 2 Summers, Oil and Gas § 306 (Perm. ed. 1927). We believe that the definition for purposes of section 17(j) must be the same as the definition for purposes of the general habendum clause. This is properly distinguished from the definition embodied in sec. 9 of the operating agreement defining the operator's drilling obligations.

4/ It should also be noted that at the time the language of the statutory habendum provision was originally adopted, in 1935, there was a substantial glut of oil on the market, and that producers were adjusting production accordingly. In reference to this economic fact of life, it was argued that "it seems only reasonable that the term of the lease should be for the productive life of the wells thereon, thus avoiding the necessity of producing all oil possible within a prescribed term regardless of conditions in the industry." S. Rep. No. 1158, 74th Cong., 1st Sess. (1935), at 4.

point of view of the lessee, a prudent operator would produce the well and thereby lessen his total loss from the drilling venture. From the point of view of the lessor, it clearly was in his economic self-interest to have the original lessee produce since it would be unlikely, should the lease be terminated, that anyone else would be willing to drill another well into the same formation where the original lessee had shown it was not economically feasible to drill. This latter rationale has an even stronger impact in Government leasing since, not only is the leasing aimed at the generation of revenues, but it is also designed to maximize domestic production of oil. Termination of leases which, while ultimately unprofitable to the lessee, could nevertheless be profitably produced, would run counter to both these purposes.

Section 9 of the unit agreement is aimed at totally different goals and, thus, the proper definition of "paying quantities" as used in section 9 necessarily involves different considerations. Unit agreements were originally authorized for Federal lands by the Act of July 3, 1930, 46 Stat. 1007, and the Act of March 4, 1931, 46 Stat. 1523. The impetus for these Acts was a combination of then depressed oil prices and the development of recovery techniques which could not be utilized on an individual permit basis. A unit agreement allowed various permittees and other holders of oil and gas rights to explore and develop the lands committed to a unit in a systematic method which minimized expenses by avoiding needless offsets, and contributed to maximum recovery from any reservoir. Insofar as unproven areas were concerned, unitization served the additional purpose of spreading out the risks inherent in the drilling of wildcat wells.

Thus, the drilling requirements of section 9 of the unit agreement are an integral part of the unit agreement. Since the first goal of a unit agreement for an unproved area is to establish the existence or nonexistence of commercially recoverable deposits, the unit operator's obligation to drill both the initial well and subsequent wells is fulfilled only where a well is completed which is, indeed, commercial. Under section 9, the drilling of a well which might produce in paying quantities, but which would never recover drilling costs, simply would not establish the existence of a reservoir which was amenable to unit production. Therefore, for the purposes of section 9, defining paying quantities as including the costs of drilling is eminently reasonable. But the question whether a well is producing in paying quantities for the purpose of section 9 of the unit agreement (and for the purposes of section 20 of the unit agreement, as we shall show below) is functionally discrete from the question whether the well is producing in paying quantities for the purposes of section 17(j), 30 U.S.C. § 226(j) (1976).

The Department has long recognized that all lands committed to an approved unit are treated as a single lease for the purposes of production, and, therefore, actual production on any lease committed to the unit is constructive production on all other leases within the unit. See Automatic Termination of Unitized Leases for Failure to Pay Rentals, M-36629, 69 I.D. 110 (1962). Moreover, insofar as individual lease extensions are concerned, actual diligent drilling operations over the expiration date of any lease committed to the unit, occurring anywhere within the unit, are sufficient to obtain the 2-year extension mandated by 30 U.S.C. § 226(e) (1976). See Integrity Oil and Gas Co., 42 IBLA 222 (1979). There seems to be no logical reason to establish, for the purpose of lease extension under 30 U.S.C.

§ 226(j) (1976), a higher threshold showing than would be required for a nonunitized lease. Indeed, the opposite could be more easily defended.

By committing his lease to a unit plan of development, the individual lessee surrenders his exclusive right to drill on his own lease in favor of the coordinated drilling plan authorized under the unit agreement. The possibility of obtaining an extension by drilling over the expiration date might thus be unavailable to a lessee where the unit agreement does not contemplate or require drilling during the critical period. It is totally inconsistent with the Government's general policy of fostering unit plans of development to at the same time establish a requirement for extension by production which is greater under a unit plan than would be for an individual lessee. In fact, carried to its logical extreme, it could be argued that even if appellant's lease contained Unit No. 1 well, there could be no extension under 30 U.S.C. § 226(j) (1976) since this was not production under the unit agreement. We reject the premise of the argument, viz., that the existence of a commercial well under section 9 of the unit plan determines the applicability of the extension provision of 30 U.S.C. § 226(j) (1976).

Finally, we note the Survey Manual based its analysis, in part, on the provisions of section 20 of the Standard Unit Agreement. Thus, the manual states that once a unit well under section 9 is determined to exist all leases committed to the unit are eligible for extension "in accordance with Section 20 of the Standard Form of Unit Agreement for Unproved Areas." This statement is simply wrong. Section 20 has absolutely nothing to do with the extension of leases committed to a unit. Section 20 relates to the extension of the unit itself. Once again, it is logical that the paying quantities test of section 9, rather than the paying quantities standard of 30 U.S.C. § 226(j) (1976) should apply in this circumstance, since production from wells incapable of recovering drilling costs would not serve to show that development under a unit plan was possible. Thus, a unit plan may only be automatically extended where a commercial well exists, since only such a well clearly establishes that unit development is viable.

In summation, we hold that, for the purposes of the extension provisions of 30 U.S.C. § 226(j) (1976), production in paying quantities requires that the well drilled be able to produce sufficient hydrocarbons to recover the costs of operating and marketing but need not recoup the costs of drilling. This being the case, the fact that the unit agreement subsequently terminated at the request of the parties is not dispositive of the question whether lease W-28314 was extended beyond its expiration date. Rather, the question is whether Unit No. 1 well was capable of production in paying quantities within the definition of 30 U.S.C. § 226(j) (1976).

It seems clear to us that both BLM and Survey proceeded below on the assumption that unless the well was commercial within the meaning of section 9 of the unit agreement, the instant lease could not be extended pursuant to 30 U.S.C. § 226(j) (1976). This we have held to be erroneous. While we note that in a letter, dated July 31, 1981, to appellant Yates the Acting Deputy Conservation Manager stated that "production from this well [Unit No. 1 well] shall be handled and reported on a lease basis," thus, implicitly agreeing that the well was capable of producing in paying quantities under the definition which we have held properly applicable herein, we feel that it would be more appropriate to permit BLM and MMS an opportunity to initially review the question. Should a determination be made that the well was capable of producing in paying quantities, the lease would have been extended by reason of production under 30 U.S.C. § 226(j) (1976), and thus would have been in esse when the unit agreement terminated. Therefore, under 30 U.S.C. § 226(j) (1976), it would be eligible for a 2-year extension provided for leases where the unit plan of development has terminated. See 43 CFR 3107.5. On the other hand, if the Unit No. 1 well was not capable of producing in paying quantities, lease W-28314 terminated on its expiration date and, thus, would not be extended under 43 CFR 3107.5.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is set aside and the case files are remanded for further action consistent herewith.

James L. Burski
Administrative Judge

We concur:

Gail M. Frazier
Administrative Judge

C. Randall Grant, Jr.
Administrative Judge